



UNIVERSITI PUTRA MALAYSIA

**AUDIT EXPECTATION GAP AND DECISION PERFORMANCE OF
IRANIAN LOAN OFFICERS**

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**AUDIT EXPECTATION GAP AND DECISION PERFORMANCE OF
IRANIAN LOAN OFFICERS**

By

AMIRHOSSEIN TAEBI NOGHONDARI

**Thesis Submitted to the Graduate School of Management,
Universiti Putra Malaysia, in Partial Fulfillment of the
Requirement for the Degree of Master of Science**

December 2007



DEDICATION

I dedicate this thesis

*To my father who taught me how should I live;
To my tender mother who instilled in me the meaning of sacrifice;
To my uncle that provide me with encouragement and care;
To my family that I owe my success due to their infinite devotion, love and support.
To my supervisor and entire committee who guide me the way throughout my research; and
To the many people that helped me to pursue my studies up to this level.*

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in
fulfilment of the requirement for the degree of Master of Science

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Chairperson: Professor Foong Soon Yau, PhD

Faculty: Graduate School of Management

External users of financial statements such as bank loan officers may have a greater reliance on audited financial statements in their decision-making due to their higher expectation of auditors' role and responsibility as compared to what is prescribed in statutes and thus, giving rise to an audit expectation gap. The existence of an audit expectation gap may cause loan officers to make poorer assessment of the credit worthiness of loan applicants that may result in their banks experiencing higher non-performing loans. This study proposes to examine the effects of individual factors on the extent of audit expectation gap and whether audit expectation gap would adversely affect loan officer decision performance. This study hypothesises that three individual factors, level of accounting qualification, accounting experience and occupation experience, to affect loan officer's perception of the role of

audit and the reliability of the audited financial statements. A questionnaire was designed based on measures used in previous studies to evaluate the extent of the audit expectation gap with respect to perceived auditors' responsibility, reliability and decision-usefulness of audit financial statements. Based on the feedback of senior bank managers of Iranian banks, this study used four indicators to measure the decision performance of loan officers, and the indicators were a) the percentage of non-performing loans, including bad and doubtful loans, b) the percentage of loans that failed to repay in the first 3 installments, c) the percentage of loans that failed to repay in more than 3 installments and, d) the percentage of loans rejected by loan officer's supervisor.

Out of the 113 questionnaires that were distributed to loan officers at the main branches of the five biggest commercial banks in Iran (Melli, Mellat, Saderat, Tejarat and Sepah), 111 questionnaires were completed and returned. Linear and multiple regression analyses indicate that accounting qualification and accounting experience have a significant and negative relationship with audit expectation gap. However, there is no significant relationship between occupational experience and audit expectation gap, but the direction of the relationship is as expected. Except for the rejected loans indicator, the results for all the other three performance indicators indicate significant and negative relationships between the loan officers' decision performance and the extent of the audit expectation gap.

The findings of this study suggest that banks should emphasise on accounting qualification and experience as crucial requirements in their recruitment of loan officers. The apparent lack of effect of occupational experience on reducing the audit expectation gap may be due to the lack of pertinent training offered by Iranian banks to their loan officers. In view of that this study recommends that the Iranian central bank should encourage banks to conduct the necessary education and training courses to loan officers to improve their knowledge of the role of audit report and responsibility of auditor as a means to reduce audit expectation gap and to enhance their understanding of the audited financial statements when assessing loan applications.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia
sebagai memenuhi sebahagian keperluan untuk ijazah Master Sains

**AUDIT EXPECTATION GAP AND DECISION PERFORMANCE OF
IRANIAN LOAN OFFICERS**

Oleh

AMIRHOSSEIN TAEBI NOGHONDARI

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Pengguna - pengguna luar penyata kewangan seperti pegawai pinjaman bank, mungkin akan berharap lebih daripada juruaudit – juruaudit, daripada apa yang mereka telah sediakan jurang jangkaan audit (Audit Expectation Gap); oleh kerana itu, ini bakal membawa risiko dimana mereka mungkin membuat keputusan yang berkualiti rendah dan bank mereka akan mengalami pinjaman tidak-berlaksana (non-performing loans) yang tinggi. Sebagai akibatnya, faktor – faktor haruslah dikenalpasti yang akan memberi peningkatan dalam jurang jangkaan dan langkah – langkah untuk mengurangkan jurang tersebut. Dalam kajian ini, tiga faktor individu, iaitu, kelayakan perakaunan, pengalaman perakaunan dan pengalaman pekerjaan didapati akan mempengaruhi tanggapan pegawai pinjaman terhadap peranan audit dan kejujuran laporan audit. Hubungan antara

jurang jangkaan audit dan keputusan perlaksanaan pegawai-pegawai pinjaman juga telah diselidik.

Berdasarkan langkah-langkah yang telah diguna dalam kajian-kajian sebelum ini untuk menilai had jurang jangkaan audit, responden-responden disoal tentang tanggapan terhadap tanggungjawab juruaudit, kejujuran serta keputusan penggunaan laporan audit. Untuk mengukur keputusan perlaksanaan tugas pegawai-pegawai pinjaman, peratus pinjaman tidak berlaksana, peratus pinjaman yang gagal dibayar balik dalam tiga ansuran pertama, peratus pinjaman yang gagal dibayar balik dalam lebih daripada tiga ansuran dan peratus pinjaman yang ditolak telah diguna sebagai petunjuk, seperti yang dicadangkan oleh pegawai-pegawai kanan bank-bank di Iran.

Daripada 113 borang soal-selidik yang telah diedar kepada pegawai-pegawai pinjaman di cawangan-cawangan utama 5 bank komersil yang terbesar di Iran (Melli, Mellat, Saderat, Tejarat dan Sepah), 111 borang soal-selidik telah lengkap diisi dan dikembalikan. Skala Linear dan Analisis Pelbagai Kemunduran (multiple regression analyses) menunjukkan bahawa, kelayakan perakaunan dan pengalaman perakaunan mempunyai hubungan yang penting dan negatif dengan jurang jangkaan audit. Walaupun demikian, pengalaman pekerjaan dan jurang jangkaan audit tidak mempunyai apa-apa hubungan yang penting; tetapi, halatuju hubungan tersebut adalah seperti yang telah dijangka. Hasil soal-selidik juga menunjukkan keputusan perlaksanaan kerja pegawai-pegawai bank

mempunyai hubungan yang penting dan negatif dengan had jurang jangkaan audit. Hasil ini adalah tetap untuk semua bahagian dalam keputusan perlaksanaan kerja pinjaman, kecuali, untuk penanda (pinjaman) yang telah ditolak.

Satu pengertian daripada pencarian ini adalah kedua-dua kelayakan perakaunan dan pengalaman harus diambil kira oleh bank-bank di Iran pada masa pengambilan kerja untuk pegawai-pegawai pinjaman. Adalah disyorkan supaya pusat bank Iran harus menekankan pendidikan dan latihan untuk pegawai-pegawai bank apabila membentuk polisi-polisi untuk sistem perbankan untuk mengurangkan pinjaman tidak-berlaksana dalam jangka masa panjang.

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I certify that an Examination Committee met on **1st October 2007** to conduct the final examination of **AMIRHOSSEIN TAEBI NOGHONDARI** on his **MASTER OF SIENCE** thesis entitled "**AUDIT EXPECTATION GAP AND DECISION PERFORMANCE OF IRANIAN LOAN OFFICERS**" in accordance with Universiti Pertanian Malaysia (Higher Degree) Act 1980 and Universiti Pertanian Malaysia (Higher Degree) Regulations 1981. The Committee recommends that the candidate be awarded the relevant degree. Members of the examination Committee are as follows:

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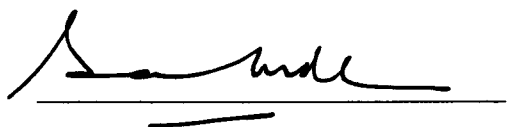
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DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations, which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or any other institutions.



AMIRHOSSEIN TAEBI NOGHONDARI

Date: 31/03/2008

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CHAPTER ONE

INTRODUCTION

1.1 Introduction

In the early years, the economic activities of companies were not too many even for auditors to verify all their clients' transactions to provide absolute assurance that there were few incidents of fraud or misstatements in their clients' financial statements. With the changing and expansion of the economic activities in almost all countries in the world, companies are becoming larger and more complicated, and so are the volumes of their business transactions with the increasing number of business transactions. Auditors have found it almost impossible to provide the absolute assurance that financial statements are free from frauds and misstatements. Therefore, standard setters have set the standards that only require auditors to provide reasonable assurance in their audit reports.

However, external users of financial statements such as the bank loan officers may have a different understanding of the nature, limitations, assurance level, and responsibility of auditors. As the consequence the loan assessment decisions might not be based on a realistic evaluation of their loan applicants' financial statements. Such misconceptions about audit role could adversely affect the loan decision performance of the loan officers.

In fact, this study examines the extent to which audit expectation gap exists among of the bank loan officers in Iran and investigates whether the extent

of the audit expectation gap affects decision performance of such loan officers.

1.2 Importance of the Research

Iran, with its plan to become a developed country in the Middle East, is the fourth richest country in the world in oil reserves and the second largest oil producer in OPEC; it has the world's second largest natural gas reserves. Iran has been of great geostrategic and geopolitics importance because of its central location in Eurasia. Iran also provides attractions to tourists due to its historical monuments and its different types of climates. Its growing automobile manufacturing, aerospace, biotechnology, nanotechnology and pharmaceuticals industries seriously necessitate an active financial and capital market, which in turn depends on the availability of appropriate financial decision making based on the information disclosed in audited financial statements. Moreover, foreign and local investors in financial markets depend on audited financial reports for investment decisions (Best *et al.*, 2001).

Therefore, the understanding of potential factors which could undermine the role of audit, especially the attest function, would increase public confidence in financial reporting which is essential for development of healthy financial and capital market (Gul and Tsui, 1992). Audit expectation gap (the difference between what the public and financial statement users believe auditors are responsible for and what auditors themselves believe their responsibilities are (AICPA, 1992)) could damage the auditing profession

and influence the efficiency of financial market by decreasing the public confidence in financial reporting. It seems there is a need to identify factors involve in the audit expectation gap and try to reduce them. Individual factors such as lack of knowledge or experience of users could affect audit expectation gap and negatively affect performance (Humphrey *et al.*, 1992). The detrimental effects of individual factors on audit expectation gap could be decreased through proper training of users with regard to information provided in the financial statements.

1.3 Justification of the Study

Having worked in an institute, which was providing accounting and auditing services to the public, the researcher often had to carry out feasibility studies for companies for purpose of obtaining loans from banks and regularly encountered loan officers who had different expectations from audit reports. As a matter of fact, loan officers do rely on audit reports in their decision making, but they have seem to have a different expectation of the audit function, such as the role or the responsibility of auditors, the requirement of the audit standards and regulations, their limitations and the nature of other specialty audits. In fact, their decisions are based on their own perceptions of the audit function that could differ from the audit requirements performed based on the standards. Consequently, their decisions may not be appropriate and the default risk level for loans may increase.

In some cases, when banks are faced with defaults or non-performing loans, as a consequence of the unrealistic expectation of the audit function, the

banks might blamed the audit firms (Mednick and Peck (1994). There is a possibility that the different expectation of loan officers could lead auditors to being sued in courts. The other element, which contributes to auditors being taken to court, is the misunderstanding of loan officers with respect to the party responsible for preparing the financial statements. Empirical evidence indicate that most of the users of financial statements presume auditors are responsible for the financial statements, instead of the corporate management (refer to Best *et al.*, 2001; Almer and Brody, 2002; Fadzly and Ahmed, 2004; Dixon *et al.*, 2006).

1.4 The Negative Consequences of Audit Expectation Gap

One of the most important banking services is to give loans to applicants. Limited sources and budgets compel loan officers to rely on certain criteria to decide on the most suitable action at the minimum risk. Most frequently, they rely on the financial statements for a better understanding of the financial status of the applicant. Audit reports provide assurance to them on whether the financial statements can be relied upon; but the existence of an audit expectation gap often leads to unrealistic assumption that could adversely affect their decision.

Therefore, various investigations about audit expectation gap could be helpful to clarify different aspects of this issue and reveal the impact of audit expectation gap on loan decision making and its outcomes. Better decision performance could be one of the desirable consequences of narrowing the audit expectation gap. The other negative aspect of audit expectation gap is

that differences in users' and auditors' beliefs about the auditing function would decrease the audit value in the long run. Efforts to investigate the causes for the misconceptions of the users about the audit function could help to improve the perception of the audit profession.

Almer and Brody (2002) argued if loan officers have different understanding of the type of audit report, one of the consequences of the miscommunication between auditor and loan officer could be that the company which is given a modified audit report may unjustifiably be denied the right to capital, because the loan officer associates higher level of risk with modified audit report. Fadzly and Ahmed (2004) explained that the existence of the expectation gap may eventually lead to severely tarnish the auditor's reputation and increase the negative perception of the value of independent audit.

The advantages of narrowing the gap are that, as McInnes (1994) indicated that the reputation audit profession could be saved and improved in the long-term. It would also help the users, who rely on auditors' work, by providing empirical evidence to show them how auditors look at auditing, in comparison to other financial experts, in order to contribute to a better understanding of the nature and significance of the gap. Examining how bankers perceive the nature, limitations and the role of audit report is of research interest because they are major capital providers for companies and they rely, in part, on financial information to make lending decisions (Danos *et al.*, 1989). If the loan officers do not possess the appropriate